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No. 07-1334

IN THE
Supreme Court of the United States

IMPROV WEST ASSOCIATES and
CALIFORNIA COMEDY, INC.,

Petitioners,

v.

COMEDY CLUB, INC. and
AL COPELAND INVESTMENTS,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY AND SUPPLEMENTAL BRIEF OF PETITIONERS

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CORPORATE DISCLOSURE STATEMENT

The Petitioners, Improv West Associates and California Comedy, Inc., have no parent corporations, and no publicly held company owns 10% or more of their stock.

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REPLY AND SUPPLEMENTAL BRIEF FOR PETITIONERS

The Ninth Circuit has vacated an arbitrator's reasoned and good faith award for "manifest disregard of the law." This is not a statutory basis for vacatur under the Federal Arbitration Act ("FAA"), and the decision should be vacated and the case remanded for further consideration in light of this Court's decision in *Hall Street Assoc., L.L.C. v. Mattel, Inc.*, 552 U.S. ___, 128 S. Ct. 1396, No. 06-989, slip op. 1-15 (March 25, 2008).

Subsequent to the Petitioners' filing of their petition for a writ of certiorari, a circuit split has arisen regarding whether "manifest disregard" is a valid ground for vacatur under the FAA after this Court's decision in *Hall Street*. The First Circuit has ruled that, after *Hall Street*, manifest disregard of the law is not a valid ground for vacating or modifying an arbitral award under the FAA. The Second and Fifth Circuits have held to the contrary, ruling that even after *Hall Street* those circuits will continue to recognize "manifest disregard" as a non-statutory basis for vacating an arbitration award. As an alternative to vacating the Ninth Circuit's decision and remanding for further consideration in light of *Hall Street*, this Court should grant the petition for the purpose of resolving this circuit split regarding the non-statutory grounds, if any, upon which an arbitration award may be vacated.

Moreover, even if "manifest disregard" remains a valid ground for vacatur after *Hall Street*,

the Ninth Circuit's decision still conflicts with the law of every other circuit because the Ninth Circuit's decision allows a court to substitute its judgment for that of an arbitrator whenever the court disagrees with the arbitrator's understanding or application of the law. Although couched in terms of "manifest disregard," the Ninth Circuit's decision in fact sanctions ***de novo*** review of arbitration awards and should not be permitted to stand.

I. A Circuit Split Now Exists Regarding Whether "Manifest Disregard" Is A Valid Ground For Vacatur Under The FAA After This Court's Decision In *Hall Street.*

At the time Petitioners filed their petition, no circuit had ruled on whether "manifest disregard" remains a valid ground for vacating or modifying an arbitration award following this Court's decision in *Hall Street*. Subsequent to Petitioners' filing of their petition, a circuit split has arisen.

The First Circuit has ruled that, after *Hall Street*, "manifest disregard of the law is not a valid ground for vacating or modifying an arbitral award in cases brought under the Federal Arbitration Act." *Ramos-Santiago v. United Parcel Serv.*, 524 F.3d 120, 124 n.3 (1st Cir. 2008). In contrast, the Second and Fifth Circuits have continued to recognize "manifest disregard" as a non-statutory basis for vacating an arbitration award. *See Abondolo v. H. & M.S. Meat Corp.*, No. 07 Civ. 3870, 2008 WL 2047612, at *2 (2d Cir. May 12, 2008) ("[I]n this Circuit, courts will 'vacate an award only upon finding a violation of one of the four statutory bases

[enumerated in the Federal Arbitration Act ...], or, more rarely, if we find a panel has acted in manifest disregard of the law.'") (quoting *Porzig v. Dresdner, Kleinwort, Benson, N.A. LLC*, 497 F.3d 133, 139 (2d Cir. 2007)); *Moore v. Potter*, No. 07-20624, 2008 WL 1874566, at *4 (5th Cir. Apr. 28, 2008) ("This Court ... recognizes that an arbitration award may be vacated when an arbitrator manifestly disregards the law, which 'is an extremely narrow, judicially-created rule with limited applicability.'") (quoting *Prestige Ford v. Ford Dealer Computer Servs., Inc.*, 324 F.3d 391, 395-96 (5th Cir. 2003)).

Because the Ninth Circuit has not ruled on the continuing viability of manifest disregard as "***a non-statutory escape valve*** from an arbitral award," *Luong v. Circuit City Stores, Inc.*, 368 F.3d 1109, 1112 (9th Cir. 2004) (emphasis added), it is appropriate for this Court to vacate the Ninth Circuit's decision in the present case (which was decided before *Hall Street*) and to remand for further consideration in light of *Hall Street*. Alternatively, this Court should grant the petition to resolve the important circuit split that now exists as to the validity of "manifest disregard" as a ground for vacatur under the FAA.

II. Even If "Manifest Disregard" Remains A Valid Ground For Vacatur Under The FAA, The Ninth Circuit's Decision Conflicts With The Law Of Every Other Circuit And Sanctions *De Novo* Review Of Arbitration Awards.

To the extent that "manifest disregard" remains a valid ground for vacatur under the FAA,

the Ninth Circuit nonetheless departed from the law of every other circuit in holding that a court may vacate or modify an arbitrator's reasoned and good faith award simply because the court believes that the arbitrator has misunderstood or misapplied the law.

The portions of the Ninth Circuit's decision quoted in Respondents' opposition brief demonstrate the unprecedented nature of the decision. Respondents first quote the Ninth Circuit's holding that "[t]he arbitrator's award, while aware of [*Dayton Time Lock Service, Inc. v. Silent Watchman Corp.*, 52 Cal. App. 3d 1, 124 Cal. Rptr. 678 (1975)], interpreted it in a way to render it inapplicable to this case." Respondents' Opp'n at 9 (quoting App. 26a). The arbitrator did not, however, find that *Dayton Time Lock* required him to rule one way yet nevertheless proceed to rule the other way, which is the defining feature of "manifest disregard." *See* Petition at 12-14 and cases cited therein. Instead, the arbitrator read *Dayton Time Lock* to provide for a "rule of reason" analysis that is applicable only in the antitrust context. Specifically, the arbitrator analyzed *Dayton Time Lock* as follows:

> "[*Dayton Time Lock*], relied on by Respondent, is inapplicable. That case involved an attack on an exclusive dealing contract under the *antitrust laws*. The cases cited in the portion of the *Dayton* opinion relied on by Respondent involved validity of exclusive dealing contracts under the federal Sherman Act. The type of "rule of reason" analysis applied in

> antitrust cases-involving the determination whether a particular agreement unreasonably restricts competition generally in a defined geographic and product market-is not applicable to a determination of illegality under Section 16600. California's antitrust statute, the Cartwright Act, is separate and distinct from §16600 of the Business & Professions Code."

App. 90a-91a. Regardless of whether the Ninth Circuit agrees with the arbitrator's reading of *Dayton Time Lock*, the arbitrator certainly did not "ignore" *Dayton Time Lock* or render a ruling in willful defiance of that case. Instead, he analyzed and applied the case as he understood it. In concluding that this reasoned and good faith decision-making constitutes "manifest disregard" for which an arbitration award may be vacated, the Ninth Circuit has effectively sanctioned ***de novo*** review of arbitration awards.

The same is true with respect to the other passage of the Ninth Circuit's decision that is quoted in Respondents' opposition, in which the Ninth Circuit held that "[t]he arbitrator's ruling ... ignores CBPC § 16600 and thus is in manifest disregard of the law." Respondents' Opp'n at 9 (quoting App. 27a). Again, however, the Arbitrator neither ignored nor acted in defiance of section 16600 of the California Business and Professions Code. Instead, the arbitrator devoted a significant portion of his ruling to section 16600 and its application to the facts before him. To illustrate the point, it is

necessary to quote the arbitrator's ruling at some length:

> "Section 16600 of the California Business & Professions Code provides that "[e]xcept as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void." This provision is "an expression of public policy to ensure that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice." *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App, 4th 853, 859 (1994). Although the language of Section 16600 is broad in scope, court decisions have upheld agreements limiting competition in a variety of contexts. For example, it has been, held that Section 16600 applies only to covenants preventing one from engaging in an entire business, trade or profession." *Campbell v. Board of Trustees of Stanford University*, 817 F. 2d 499, 502 (9th Cir. 1987). And covenants not to compete *during the term* of an employment agreement or distribution contract are regularly upheld. *Shaklee U.S., Inc. v. Giddens*, 1991 U.S. App. LEXIS 11617, *8-9 (9th Cir. 1991).
>
> ...
>
> "The authorities cited by the parties support the enforceability of in-

term covenants not to compete. Such covenants have been held enforceable during the terms of employments agreements, *Fowler v. Varian Assoc's Inc.*, 196 Cal. App. 3d 34, 44 (1987), supplier-distributor agreements, *Shaklee U.S., Inc. v. Giddens*, 1991 U.S. App. LEXIS 11617 (9th Cir. 1991), and franchise agreements. *Keating v. Baskin-Robbins, USA, Co.*, 2001 WL 407017 (E.D.N.C.) (applying California law) and *Great Frame-Up Systems, Inc. v. Jazayeri Enterprises, Inc.*, 789 F. Supp. 253 (E.D. Ill. 1992) (applying California law). Although the reasoning in these decisions is sparse, they do emphasize that in-term restrictions are only "partial" restraints on competition, because the restrained party (whether employee, distributor or franchisee) may continue to engage in the relevant business during the term of his or her agreement with the employer, supplier or franchisor. Respondent has not cited any decision invalidating in-term covenants not to compete under Section 16600.[6] The arbitrator finds, therefore, that paragraph

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"[6] Respondent has cited authorities striking down covenants not to compete in franchise or similar agreements *after* expiration of the contract term, but such decisions are inapplicable to paragraph 9.j as construed herein. *E.g., Scott v. Snelling and Snelling*, 732 F. Supp, 1034, 1042 (N.D. Cal. 1990); *Latona v. Aetna U.S. Healthcare, Inc.*, 82 F. Supp, 2d 1089, 1094 (CD, Cal. 1999)."

9.j of the Agreement is a valid and enforceable in-term covenant under California law.

"Alternatively, even if the paragraph 9.j covenant could be construed to extend beyond the contract term, it is enforceable up to the end of the contract term under California's "rule of severability," allowing enforcement of overbroad covenants up to their lawful temporal and geographical limits, *Swenson v. File.*, 3 Cal. 3d 389, 395 (1970); *Hill Medical Corp. v. Wycoff*, 86 Cal. App. 4th 895, 908 (2001). These decisions are more applicable to the present fact situation than *Kolani v. Gluska*, 64 Cal. App. 4th 402, 407-08 (1998), relied on by Respondent, which declined to convert an invalid covenant not to compete into valid trade secret protection clause. *Latona v. Aetna U.S. Healthcare, Inc.*, is also distinguishable. *Latona* held that an employer violated California public policy by firing an employee who refused to sign a covenant not to compete that violated Section 16600. The covenant prohibited all competition by the employee for six months after termination of employment, and thus clearly violated Section 16600. The Court held that the employer could not excuse its conduct by asking the Court to "reform" the contract to make it valid, either by excising the post-employment

> restraint or by converting it into a trade secret protection clause. The Court noted the *in terrorem* of allowing employers who require employees to sign Invalid covenants to use the Courts to reform such agreements when challenged. Such fact situations arc far removed from the present case, where the covenant does not expressly extend beyond the contract term and the parties are equally sophisticated and alert to their legal rights."

App. 104a-109a. The arbitrator further analyzed section 16600 in ruling on the Respondents' motion for reconsideration:

> "This motion amplifies an argument made in Respondent's reply memorandum (pp. 17- 20), which the arbitrator considered in making his summary adjudication ruling. The present motion is not a motion for reconsideration in the usual sense – no new law or newly discovered facts are cited. However, arbitration procedures are more flexible than court litigation and the motion will be considered on the merits.
>
> "Decisions assessing covenants not to compete under California Business & Professions Code §16600 consider whether the contract imposes total or partial restraints. *Campbell v. Board of*

Trustees, 817 F. 2d 499 (9th Cir. 1987). However, unlike some other states, California does not apply a "reasonableness" test in assessing the validity of a contractual restriction under §16600. *Campbell*, *supra* at 502; *Commercial Packaging. Inc. v. TIPS Package Engineering. Inc.*, 126 F. 3d 1131, 1133 (9th Cir. 1997).

"As determined in the summary adjudication order, the covenant not to compete in paragraph 9j of the Trademark License Agreement is a partial restraint on Respondent's ability to engage in the comedy club business. Indeed, the Agreement provides a framework for Respondent to engage in the comedy club business during the term of the Agreement, but only as a licensee of Claimant.

"Respondent argues that the covenant not to compete in paragraph 9j of the Trademark License Agreement will unreasonably impact Respondent, because of the limited number of clubs Respondent currently operates, the uncertain financial status of these clubs and Respondents' loss of its right to license additional clubs under the Agreement. This type of "unreasonableness" argument is not available under California law. *Id.* Moreover, Respondent's loss of the right

> to license new IMPROV clubs results from its own breach of the Agreement by failing to meet the development schedule, and Respondent should not be allowed to use its own default to invalidate an otherwise valid partial restraint on competition."

App. 89a-91a.

As above, there can be no question that the arbitrator analyzed and applied section 16600 as he understood it. The Ninth Circuit's ruling that the arbitrator "ignored" and acted in "manifest disregard" of section 16600 cannot be reconciled with the arbitrator's extensive discussion and reasoned analysis of section 16600. In truth, the Ninth Circuit simply disagreed with the arbitrator's reading of section 16600 and vacated the award on that basis. This ***de novo*** review of the arbitrator's award conflicts with the extremely limited review of arbitration awards provided for in the FAA and the decisions of every other circuit and, if permitted to stand, will open the floodgates to plenary review of arbitration awards.

* * *

For the foregoing reasons and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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